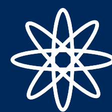

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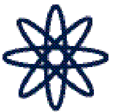
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

A supportive background for international equities, namely solid economic growth, rising corporate earnings and dividends and significant merger and acquisition activity, has been reflected in positive returns for equity investors over the quarter. By way of contrast, the continued overvaluation of bonds has resulted in a quarter of negative returns for international bond investors.

The tables below detail relevant movements in markets:

International Equities 30.03.07 – 29.06.07

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	+5.7	+8.5	+11.0	+9.4
Finland	+15.0	+14.0	+16.7	+15.0
France	+9.2	+8.3	+10.8	+9.2
Germany	+15.3	+14.3	+16.9	+15.3
Hong Kong, China	+10.7	+8.2	+10.7	+9.1
Italy	+4.1	+3.3	+5.6	+4.1
Japan	+4.1	-2.7	-0.4	-1.9
Netherlands	+6.0	+5.1	+7.5	+6.0
Spain	+3.1	+2.3	+4.6	+3.1
Switzerland	+4.3	+1.6	+3.9	+2.4
UK	+5.5	+5.5	+7.9	+6.4
USA	+6.1	+3.7	+6.1	+4.6
Europe ex UK	+8.0	+7.0	+9.4	+7.8
Asia Pacific ex Japan	+10.5	+10.5	+13.1	+11.4
Asia Pacific	+6.9	+3.0	+5.4	+3.9
Latin America	+14.7	+17.1	+19.8	+18.1
All World All Emerging	+12.8	+13.0	+15.6	+13.9
The World	+6.7	+5.0	+7.4	+5.8

Source FTS E World Indices

FT Government Securities Index All Stocks (total return): -2.3%

International Bonds – Benchmark Ten Year Government Bond Yields (%)

Currency	30.03.07	29.06.07
Sterling	4.94	5.46
US Dollar	4.65	5.04
Yen	1.66	1.87
Germany (Euro)	4.06	4.56

Sterling's performance during the quarter ending 29.06.07 (%)

Currency	Quarter Ending 29.06.07
US Dollar	+2.3
Canadian Dollar	-5.7
Yen	+7.0
Euro	+0.8
Swiss Franc	+2.7

Other currency movements during the quarter ending 29.06.07 (%)

Other Currency	Quarter Ending 29.06.07
US Dollar/Canadian Dollar	-7.7
US Dollar/Yen	+4.6
US Dollar/Euro	-1.4
Swiss Franc/Euro	-1.8
Euro/Yen	+6.1

Significant Commodities (US dollar terms) 30.03.07 – 29.06.07 (%)

Significant Commodities	28.02.07 – 31.05.07
Oil	+3.8
Gold	-2.0

Markets

International equity markets were generally firm during the second quarter of the year with all main markets, in local currency terms, showing a positive return. In local currency terms, the FTSE World Index showed a total return of 6.7%, in sterling terms 5.0%, in US dollar terms 7.4% and in euro terms 5.8%. Looking at total returns in local currency first, Europe ex UK, of the major regions, performed best with a return of 8.0%, whilst, as measured by the relevant FTSE index, the USA returned 6.1%, the UK 5.5% and Japan 4.1%. Asia Pacific ex Japan, Latin America and emerging markets were outstanding with respective returns of 10.5%, 14.7% and 12.8% respectively. Within the Europe ex UK section, Germany and Finland were outstanding (the latter because of Nokia) with respective returns of 15.3% and 15.0%. If we look at the sterling adjusted picture, the Europe ex UK return reduced to a still very good 7.0% whilst the US return goes down to a still more than satisfactory 3.7%. The significant weakness of the yen turns a positive local currency return of 4.1% to a negative return of 2.7%, the Japanese currency adjusted returns being the only negative feature in the tables. On the other hand, an excellent 5.7% local currency return in Australia turned into an even better 8.5% return in sterling terms on the back of a very strong Australian dollar. Outstanding local currency returns from Latin America and emerging markets of 14.7% and 12.8% turned into even better sterling adjusted returns of 17.1% and 13.0%.

The positive performance of international equities contrasts with a grim quarter for bonds. Taking ten year government bonds as a benchmark, sterling gross redemption yields rose by 52 basis points to 5.46%, US dollar bonds by 39 basis points to 5.04%, yen bonds by 21 basis points to 1.87% and German euro denominated bonds by 50 basis points to 4.56%.

There were some significant currency movements during the quarter, with the yen and Canadian dollar being particular features. Against the yen, sterling rose by 7.0% but, against the Canadian dollar, it fell by 5.7%.

Sterling was quite strong against the US dollar and Swiss Franc with rises of 2.3% and 2.7% respectively, and it experienced a small rise against the euro of 0.8%.

Oil, as measured by Brent crude, was slightly higher, 3.8%, in US dollar terms, whilst gold declined by 2.0%.

Economics

- *The economic background remains generally benign* ...... the OECD forecasts 2.7% growth for this year and next amongst its members whilst the IMF, in a slightly earlier forecast, suggests 4.9% growth for the world economy this year and next. This is a good environment for continuing earnings and dividend increases, as well as corporate activity.
- *The Bank for International Settlements in its recently published report mentions concerns* ...... rising inflationary pressures, the vulnerability of the US economy (and, by extension, elsewhere) to a housing induced slowdown, global imbalances and financial markets "priced to perfection".
- *We would add another concern, protectionism, which we consider the most important threat to the world economy* ...... developments in the USA and EU need watching. At its worst, protectionism could induce a world economic recession and the pressures placed upon China risk a backlash.
- *Attacks on private equity by politicians and trade unionists gather pace in the UK and USA* ...... concentrations of enormous wealth attract attention and may lead to some limited taxation measures.
- *The emergence of vast Sovereign Wealth Funds mainly in Asia and the Middle East could be a positive development for equity investors* ...... providing there is not a protectionist backlash, this could be positive for investors although a diversion of funds from bonds could raise yields above what they would have been.
- *A disappointment at the recent EU summit* ...... Mr Sarkozy gets his way and the words "undistorted competition" are removed from the EU's objectives.
- *Problems in the US sub prime mortgage markets cause issues elsewhere* ...... some hedge funds have difficulties and credit markets become nervous. If that leads to a more sensible pricing of risk, that is good news although it could cause substantial pain along the way.
- *Moreover, the "carry trade" strategy continues* ...... this has left the yen very depressed but the strategy carries enormous risks.
- *Apart from the USA and Japan, central banks generally continue their policy of monetary tightening* ...... inflation and money supply growth concern the ECB and Bank of England although monetary policy cannot be called tight.

USA

- *Slow growth in the first quarter but it is expected to accelerate throughout the rest of the year* ...... annualised growth was just 0.7% held down by weakness in the housing market, a wider trade deficit and inventory depletion
- *The Federal Reserve's Beige Book is quite positive* ...... most districts report "modest or moderate" growth.
- *US interest rates are likely to remain unchanged for a while* ...... The Federal Reserve's main concern is inflation and it does not want to risk cutting rates too early. Inflation is slightly higher than it would wish to see but not alarmingly so.
- *An optimistic forecast for the US economy* ...... the White House Council of Economic Advisers, the Office of Management & Budget and the Treasury forecast 2.3% growth for this year and 3.1% for 2008 and 2009.
- *The issue is whether the US economy can withstand the weakness of the housing market* ...... it probably can, with short term indicators looking more positive.

Japan

- *Very low Japanese interest rates depress the yen* …… carry traders continue to borrow yen to convert into higher yielding currencies.
- *But it is difficult for the Bank of Japan to justify an interest rate increase much as it would like to operate a more normal monetary policy* …… there is just no inflation.
- *The economy is performing well* …… the first quarter growth estimate has been raised from 0.6% to 0.8% to equate to an annualised rate of 3.3%.
- *Foreign investors now account for 28% of the Japanese stock market* …… they can be expected to press their shareholder value culture on Japanese companies.

China

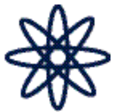
- *The authorities are trying to dampen down excesses in the Chinese economy* …… they triple stamp duty to discourage a speculative bubble in the domestic share market. They are also facilitating more overseas securities' investment for Chinese citizens.
- *China is moving to obtain a higher rate of return on part of its reserves* …… it allocates around US$200 billion for its state investment agency. This is equivalent to about one sixth of its foreign exchange reserves.

Europe Ex UK

- *Interest rates are raised again* …… in June, the ECB raises the eurozone interest rate to 4%. It raises its inflation forecast for this year to a mid point of 2.0% with the same figure for next year.
- *Monetary data, which the ECB watched closely, is still highly expansionary* …… money supply annual growth rose to 10.7% in May whilst lending to business rose at an annual rate of 12.6%. The figures for lending for house purchases and to individuals were 8.0% and 7.4% respectively.
- *The German economy continues to perform well* …… state spending, as a percentage of GDP, is on the way down and unemployment continues to fall, to give two examples. But retail sales are weak and investor sentiment shows a downturn.
- *France is the most interesting country in the eurozone at present* …… this is because of the economic and labour market reforms which Mr. Sarkozy proposes to implement. With the momentum behind him, now is the best time to try to implement them.

UK

- *Interest rates are on the way up* …… but not as quickly as the Governor of the Bank of England would have liked – he was outvoted at June's meeting.
- *The Governor and the other hawks at the June meeting were concerned about inflation* …… it remains well above target.
- *News from the housing market is inconclusive* …… the various providers of data on house prices are not consistent in what they are showing but there is tentative evidence that the series of interest rate increases is beginning to have an effect.
- *Consumers are financially stretched and not in a good position to face further interest rate increases* …… the savings ratio is at its lowest level since the early 1960's, at 2.1% in the first quarter.



Summary

- *The economic outlook remains good* ...... but, deliberately, we have emphasised in this review the issues that could upset this outlook. This is not because we are negative – we are not. It is that in some areas of the financial markets, excessive risk is being taken and it would be healthy if this were unwound.
- *Whilst we believe equities are well supported by fundamentals and the economic outlook, we should recognise the possibility of a negative quarter or two* ...... however, provided the outlook remains positive for equities, we would not introduce liquidity as it is too dangerous in terms of potential opportunity cost when it is probable that equities will continue to rise in the medium term.
- *Despite weakness in the bond markets, we still continue to believe that yields are too low* ...... inflation risks remain.

Over the quarter, the contrasting performances of equities and bonds reflect satisfactory international growth prospects, which should continue to benefit corporate earnings and dividends, on the one hand, and fears that inflation and, in the case of lower grade bonds, risk, may not be correctly priced into bonds, on the other. Economic growth prospects look satisfactory as an abridged summary from the latest economic projections contained in the latest OECD Economic Outlook show.

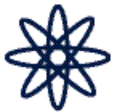
An abridged summary of the OECD's latest projections are as follows :

Real GDP Growth (%)

	2006	2007	2008
USA	3.3	2.1	2.5
Japan	2.2	2.4	2.1
Eurozone	2.8	2.7	2.3
UK	2.8	2.7	2.5
Total OECD	3.2	2.7	2.7
China	10.7	10.4	10.4
India	9.0	8.5	8.0
Russia	6.7	6.5	5.8

Inflation (%)

	2006	2007	2008
USA	2.9	2.6	2.2
Japan	(0.9)	(0.4)	0.2
Eurozone	1.7	2.0	2.0
Total OECD	2.2	2.1	2.0



Current Account Balances as a % of GDP

	2006	2007	2008
USA	(6.5)	(6.1)	(6.2)
Japan	3.9	4.8	5.4
Eurozone	0.1	0.4	0.4
Total OECD	(1.9)	(1.5)	(1.5)
China	9.5	10.2	10.6
India	(1.3)	(1.8)	(2.0)
Russia	9.8	6.2	3.8

Cyclically Adjusted Fiscal Balance as a % of GDP

	2006	2007	2008
USA	(2.5)	(2.8)	(2.8)
Japan	(2.2)	(2.7)	(3.2)
Eurozone	(1.0)	(0.8)	(0.7)
Total OECD	(1.7)	(1.8)	(1.9)

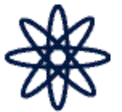
Source : OECD Economic Review

The introduction to the OECD's Economic Outlook is quite positive. It says "our central forecast remains indeed quite benign: a soft landing in the United States, a strong and sustained recovery in Europe, a solid trajectory in Japan and buoyant activity in China and India. In line with recent trends, sustained growth in OECD economies would be underpinned by strong job creation and falling unemployment". However, even the most benign outlook must be qualified with warnings or expressions of concern. The OECD mentions inflationary worries and suggests a further tightening of monetary policy in a number of countries, but not Japan. It is concerned that many countries are not using better economic conditions to address structural budget deficit problems. With its latest Economic Outlook, the OECD produced research suggesting that better outcomes on this issue arise from fiscal consolidation occurring after a fiscal crisis and that action on the expenditure side is more effective. Benign economic conditions make it easy for politicians to duck difficult economic decisions but that is exactly the time when they should be made.

The central bankers' bank, the Bank for International Settlements, whilst acknowledging the extraordinary performance of the international economy in recent years points to four areas of concern: rising inflationary pressures, the vulnerability of the US economy to a housing induced slowdown and the wider effects this could have on other countries, global imbalances and financial markets, as it describes, "priced to perfection".

Ignoring equity market valuations for a moment, the current environment is one where corporate earnings should continue to increase, albeit at not quite the rate of previous years as growth is expected to be a little slower. As a result, dividends should increase, too, and companies will also find other ways of rewarding shareholders, through buybacks for instance. Even though equity prices are now in their fifth year of growth, corporate earnings have risen very rapidly, too. In some cases, there has been a downrating of shares because they have not kept up with earnings increases. Overall, the price/earnings ratio of most major markets looks reassuring and earnings yields, the reciprocal of the price/earnings ratio, comfortably exceeds, say, ten year government bond yields, notwithstanding the recent rise in the latter.

Although the rise in interest rates slightly reduces the attraction of takeovers whether by quoted companies or private equity, the mathematics still remains compelling for many deals and we expect a continuation of merger



and acquisition activity in international markets although concerns in the credit markets may have an impact in terms of increased difficulty in raising funds. This will, almost certainly, remain a positive factor for international equity markets. So, too, will the de-equitisation of markets which occurs through companies leaving the market, because they have been taken over, or because of share buy backs. These continue to be an important feature of the current market scene with very significant quantities of shares being retired. Again, the relationships between share ratings and interest rates is favourable for this activity.

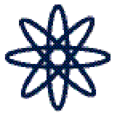
We mention above private equity which has come under sustained attack in the UK and, to a lesser but still significant way, through tax proposals in the USA. It looks very likely that tax changes will be made in the UK to raise the rate paid on gains. It may make private equity a less attractive proposition for some and may, therefore, contribute to a lower level of activity. One's best guess, at this stage, is that the effect will be marginal. If these attacks herald something stronger in the form of more pressure on the current economic system, then there will be problems. At present, these seem unlikely and, although it may act to raise the tax rate on private equity (although this would be complex), the UK government does not seem to be responding strongly to pressure being placed upon it, mindful of the importance of the financial sector to the UK economy.

Another issue of importance for investors is the rapidly rising power of Asia and the Middle East, driven by the rapid growth of China and the huge additional wealth created by the oil price increase. The large current account deficit in the USA finds its counterpart in the surpluses of these regions which have left them with enormous foreign exchange reserves traditionally invested in foreign bonds, notably US Treasuries, or short term bills or deposits. But these, of course, are relatively low yielding assets and with the size to which the reserves have grown (China, for example, has foreign exchange reserves of over US$1,200 billion), some countries are looking for ways of raising the return on their reserves or, at least, part of them. The growth of Sovereign Wealth Funds is gaining more attention. In so far as these are invested in equities, they may have an effect on international equity markets and be quite positive for them. Conversely, if they represent funds directed from US Treasury bonds, this may cause yields to be higher than they would otherwise be. One must hope that investment by Sovereign Wealth Funds does not create a political backlash. In the current atmosphere where latent protectionism is an issue, one must watch for the sort of backlash which occurred in the USA when Dubai bought P & O and was eventually forced to hive off its US east coast ports.

As Middle Eastern countries seek to diversify their economies, their enormous financial might benefits western companies. The Paris Air Show saw Qatar Airways place a vast order to buy 80 of the new A350XWB aircraft from Airbus. Qatar has a small population but its huge wealth effectively enables Airbus to launch a major new aircraft project and gives Qatar an opportunity to diversify its economy by acting as a major airline hub between east and west. Etihad, the airline of Abu Dhabi, is doing the same as Abu Dhabi, with 150 years of oil reserves, also tries to diversify its sources of income and widen the base of its economy. In Dubai, where oil reserves will soon be exhausted, Emirates has again increased its orders for the A380 to become by far the largest purchaser of the aircraft. These orders, placed by countries with small populations, are beyond the resources of nearly every major western airline but help to provide support for important elements of western manufacturing sectors.

So, the landscape in terms of trade and asset purchases is changing quickly and investors need to factor this into their investment thinking.

We have touched upon protectionism and, to us, this is the greatest threat to an otherwise satisfactory outlook. We see this in the USA and the eurozone, particularly France. In the USA, in particular, certain members of Congress have targeted China, citing its huge current account surplus and accusing it of currency manipulation in the form of keeping it artificially depressed. Whilst the Administration has tried to fend off these protectionist tendencies, the change in control in Congress with the Democrats in charge of both houses has swelled the ranks of protectionists. This is an unfortunate development and an example of being careful of what you wish for. A country like the USA, which is running a substantial current account deficit, relies on flows of foreign capital to



finance that deficit. This it has been able to do. However, its ever increasing foreign liabilities render it vulnerable to switches in the mix of other countries' foreign exchange reserves. If China, for example, took umbrage at any action Congress might take, it has the ability to cause major problems for the US dollar by, for example, rearranging its reserves. The major complaint by those advocating action against China is that it is artificially restraining its currency from rising with the result that its competitive edge is leading to ever larger trade surpluses. There are a number of points to be made. Many of the major industrialised countries have stopped making goods that are now imported from China. Therefore, if the renminbi were to rise appreciably in value, import substitution would not be practicable and inflation in the relevant industrialised country would rise. It would be very difficult, if not impossible, for manufacturing capacity to re-establish itself in the relevant industrialised country. If we take the USA, for example, its problem is a very low level of savings which necessitates the import of foreign capital. Were the US savings ratio to increase dramatically, the reliance on foreign savings would fall. So, some of its perceived problem is in its own hands. It is in the interests of industrialised countries that the Chinese economy grows rapidly. Internally, it helps to preserve the social fabric as rapid economic growth is necessary to absorb all those coming into urban areas from rural China. A stable China provides a good background for rapid economic growth which helps to drive the world economy. Protectionists everywhere should be aware of the malign economic effects of, say, tariffs or quotas. Such measures slow growth and reduce consumer and business purchasing power. Low priced Chinese imports have helped to keep down inflation and increase consumers' purchasing power, thus stimulating growth. Of course, there have been losers in the process but, overall, the benefits to the world economy of Chinese and Indian growth have been much greater. So, this is why in looking at the prospects of international securities' markets, we need to dwell on the dangers of protectionism. We think that this is the biggest danger to world securities' markets.

Nearer home, the recent EU summit which agreed to the removal of the words "undistorted competition" as an EU objective, has rightly caused dismay. This change was put forward by the new French President and is a move towards protectionism however much other leaders might protest that nothing has changed. France is, of course, particularly keen to protect its national champions but protectionism of this type comes at an economic cost. This event is a major disappointment, however it is dressed up, and we await how changes in policy will unfold.

Another issue has been the consequences of problems in the US sub prime mortgage market which have spread to credit markets and caused problems at several hedge funds. These will affect investors and financial institutions concerned with the areas in difficulty but might, in the longer term, have a beneficial effect if risk is repriced. We are dealing here with some extremely complex instruments where the hope is that risk has been laid off adequately. But, inevitably, there is going to be trouble when investors become too complacent and take too many risks and, for some time, we have indicated in these reviews where we think there could be problems. Following upon the above, we have mentioned inadequate yield premiums on low grade bonds, some areas of the property market and the carry trade. We have also been concerned that bond yields generally have been too low although these are now starting to correct.

Given the robust state of the world economy, these problems are probably containable but they are going to cause pain to certain investors and companies. Obviously, this is an important issue for investors, generally, to watch.

A feature of the quarter, as well as the rise in longer term interest rates, has been the rise in short term interest rates as a number of central banks have continued to tighten monetary policy. This has not happened in the USA, where the Federal Reserve has kept interest rates unchanged for a year or, in Japan, when they were last changed in February, but, in other important centres, they have been rising, reflecting buoyant economic growth and the fear that inflation could rise. Nowhere, can one say that monetary policy is tight but central banks continue to monitor relevant data, including money supply growth which has been capturing much greater attention, for example in the eurozone (where the ECB has always paid attention to it) and the UK. Monetary growth in these two areas has been rising at a rate well in excess of nominal GDP growth.

As our table at the beginning shows, oil continues to edge up in price with Brent crude standing at over US$70 a barrel. OPEC has been effective in managing output to impose supply constraints and with regular interruption to oil supplies from countries such as Nigeria, the price has responded. It would appear that OPEC's target price is rising all the time. The world economy can absorb the rising price better when it is growing at a healthy rate, as at present, because it is able to obtain supplies of oil, albeit at a price. This is a different, and much better situation, than a supply shock when supplies are cut drastically for whatever reason. At the moment, the position is manageable but needs watching closely.

Politics can be as important as economics in markets and there is one trend which investors need to watch. A lot of attention is being given to the vast wealth which is being created in certain areas of finance, for example, amongst hedge fund managers and private equity owners. Whilst the present furore in the UK surrounding the tax rates on private equity gains is but one example, there are more indirect effects of concentrated wealth such as the inexorable rise in London house prices which is pricing many out of the market and could fuel resentment. Some of the same issues are being raised in the USA as well. Coming together with rising protectionist sentiment, the danger is that politicians will react to this in ways which damage the business environment. We are not flagging this as a danger at the moment but the trend does need careful monitoring.

We turn now to discuss individual countries and regions, starting with the USA where equity markets have enjoyed a very satisfactory quarter, albeit with returns for foreign investors pared by weakness in the US dollar. As everyone knows, the first quarter was a weak one for the US economy with annualised growth at 0.7%. Factors contributing to low growth were weakness in the housing market, a wider trade deficit than originally thought and inventory depletion, although there was a slight increase in business investment. However, there are expectations that the second quarter will mark the start of a recovery, a view supported by the Chairman of the Federal Reserve. The Federal Reserve's Beige Book is a useful indicator of the state of the US economy and May's survey was positive. It reported an expansion of economic activity between mid April and May, with most districts reporting "modest or moderate" growth. It reported a positive trend in consumer spending and retail sales. Some strength in the jobs market was noted with tightness in the market for those with specialist skills.

Whilst US interest rates have remained unchanged for a year, opinion is still divided about the Federal Reserve's next move. It is clear that the Federal Reserve's main worry is inflation even though the trend is more encouraging and it has acknowledged the latter although waiting to see more sustained evidence. It does not appear to be unduly concerned about the problems in areas of the US credit market connected with sub-prime loans. If the issue did become serious, it would no doubt act to ease the situation for financial institutions as the Federal Reserve did all those years ago with the problems in the savings and loan industry when it engineered a reduction in short term interest rates so that banks could rebuild their profitability through benefiting from the shape of the yield curve.

During June, the twice yearly forecast from the White House Council of Economic Advisers, the Office of Management and Budget and the Treasury was issued. It forecast strengthening growth through 2007 and forecast growth of 3.1% in both 2008 and 2009. For 2007, the growth forecast was reduced to 2.3% compared with the previous forecast of 2.9%. The forecast for an upswing in the economy during the balance of the year was predicated on low unemployment and the lean level, as they are described, of inventories with industrial production on the rise. Unemployment is expected to average 4.5% for the balance of this year before rising to 4.7% in 2008 and 4.8% in 2009.

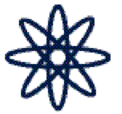
June has also seen the publication of the IMF's annual report on the US economy. It plans more emphasis on what could go wrong whilst accepting the general view that "the most likely scenario is a soft landing". It refers to a "stall speed" for the US economy which has been associated with past recessions, the rate being around 2%. It provided support for the Federal Reserve's emphasis on inflation risks whilst supporting the Federal Reserve's view that inflation was likely to come down. The IMF professed itself reasonably sanguine about the USA's large current account deficit suggesting that it could easily be funded through debt markets.

The news on inflation is better but provides no room for complacency. Core consumer prices rose by 0.1% in May whilst, because of rising energy costs, the full consumer price index rose by 0.7% to give annual rates of 2.2% and 2.7% respectively. The Federal Reserve's preferred measure, the core personal consumption expenditure index, which it is believed it would prefer to keep at a maximum rate of 2%, showed an annualised increase of 2.4% for the first quarter. The annualised rate of increase for May was down to 1.9%. Producer prices rose by 0.9% in May but at 0.2% at the core level. So, whilst these figures should not cause the Federal Reserve to consider raising interest rates in the near future, especially with first quarter growth having been weak, neither will they give them any reason to lower interest rates. For the foreseeable future, it is unlikely that the Federal Reserve will feel the need to charge interest rates.

Whilst the US economy showed weakness in the first quarter, unemployment, as we noted, remained low. In these circumstances, it was unsurprising that productivity growth slowed. The annualised rate of productivity growth in the first quarter was 1.0%, raising the growth rate of unit labour costs to 1.8%. One theory put forward for the decline in productivity growth is the apparent hoarding of labour in the housing construction industry where the downturn in activity has not been reflected in a fall in the numbers employed in the industry. The belief is that this phenomenon has distorted the overall productivity figures.

In terms of individual items of news, the ISM services index showed a strong rise from 56.0 in April to 59.7 in May. The ISM's manufacturing index for June, which has just been released, was also positive showing a rise from 55.0 in May to 56.0. There is encouraging news, too, on exports with a rise to record levels in April. The lagged effect of the more competitive dollar, plus vibrant growth in many of the USA's overseas markets, is a helpful background. Perhaps, reflecting the relative weakness of the US economy in the first quarter, imports fell by 1.9%. A rise in exports would be a high quality boost to US growth. Retail sales were strong in May, rising by 1.4% with strength everywhere. Evidence of savings being drawn down to finance consumption comes from data for May showing that consumption rose by 0.5% whilst personal income rose by 0.4%. Whilst this is not a position which can continue indefinitely, it shows a degree of confidence amongst US consumers. However, whether this will continue is an issue raised by the Conference Board's latest index of consumer confidence showing a fall in June to 103.9 from 108.5 in May. One of the items of negative news was a fall in durable goods orders in May. They were down 2.8% on the back of weaker aircraft orders. However, these are notoriously volatile and Boeing has been receiving significant aircraft orders even though it fell well behind Airbus at the Paris Air Show. Boeing announces orders when they are received rather than basing announcements round any particular event. Like Airbus, Boeing has a very long order book so orders slow down as early delivery slots are not available. On the other hand, airlines' fears about not being able to secure early delivery slots may make them more inclined to order aircraft for very distant delivery in order not to risk being uncompetitive. When erratic aircraft orders are cited as a reason for volatility in the durable goods' orders, this situation should be considered. Stripping out orders for transport equipment, there was still a 1% decline so this series of data will need to be watched as one month's figures are not statistically significant.

The main issues for the US economy are whether the housing market's weakness will affect the wider economy, apart from being the cause of depressed growth figures in the first quarter, and whether weakness in the sub-prime credit market will cause waves in the financial system, apart from problems for individual hedge funds which have followed a risky strategy. At present, we feel that the US can cope with these issues. In the case of the housing market, the inventory overhang will eventually rectify itself through the mechanism of market forces – the hope had been that this would be later this year. In the case of problems in the credit market, the banks' strong balance sheets are a cause for comfort. If the problems in the market, which have spread to some hedge funds, result in a more appropriate pricing of risk and less risk being taken, then so much the better. At present, we think the US economy can get through these two issues.



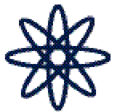
We move now to Japan which is the one market, in a positive quarter for international equities, which might have disappointed investors because of currency weakness. The decline in the value of the yen cannot be attributed to economic problems or currency manipulation since the Bank of Japan has not been intervening to depress the currency. It is the low interest rate environment which encourages the borrowing of yen, at minimal cost, to invest in high yielding assets in other currencies to benefit from the yield differential. Normally, when a currency is weak, inflationary problems develop leading central banks to raise interest rates to counteract inflation. Despite the weakness of the yen, Japan is finding it difficult to establish any level of inflation and, therefore, justify the further interest rate increases which the Bank of Japan would like to see as part of its aim of establishing a more normal monetary policy. But this is not easy, with core inflation in negative territory and the average monthly wage paid to corporate employees falling 0.7% in April compared with a year earlier. The present situation of no inflation and a weak currency is wonderful news to Japanese exporters but their happy position is not a result of currency manipulation.

The carry traders are, we consider, running a big risk. Japan runs a large current account surplus and, whilst this might not seem relevant when there are large capital outflows, it does point to a country with some strength. Contrast this position with one of the currencies which has been been bought with the yen switched, the New Zealand dollar. With the official short term interest rate at 8%, compared with 0.5% for Japan, the 7.5% advantage might seem a no brainer. New Zealand's central bank sold its currency to send a signal to the market but to little effect other than in the short term. But New Zealand has a current account deficit of around 9% of GDP compared with a surplus of around 4% for Japan. This carry trade looks like an accident waiting to happen and is evidence of extremely high levels of risk being taken by some investors. Meanwhile, there is not a lot the Japanese authorities can do about the present situation. Raising nominal interest rates would, in the present circumstances, mean raising real interest rates and that hardly seems an appropriate response to the present position even though the Japanese economy is growing quite satisfactorily.

In fact, the estimate of first quarter Japanese economic growth has been raised from a preliminary estimate of 0.6% to 0.8% quarter on quarter to equate with an annualised increase of 3.3% against the first estimate of 2.4%. This was faster than growth in the USA or the eurozone. Although this rate of growth is considered to be above the long term growth potential of the Japanese economy, the lack of inflation does not justify an interest rate increase to dampen economic growth. After keeping interest rates unchanged at its June meeting, the Governor of the Bank of Japan indicated that the Bank needed to be more convinced about the economic outlook and the sustainability of domestic demand such as capital spending and household consumption. One indicator might make the Bank of Japan cautious about raising interest rates and that is that Japanese industrial production fell by 0.4% in May, perhaps validating the Governor's caution.

Although the Japanese stock market has been relatively disappointing, we remain of the belief that it should form a modest part of an international equity portfolio. Apart from the fact that the economy is performing quite well, as we have just seen, companies have been becoming more shareholder friendly, for example in the field of dividend increases. In the context of shareholder value, it is worth noting that, in March, foreign investors accounted for 28% of the Japanese stock market. Foreign investors will pressure Japanese companies to enhance the cause of shareholder value, something that should, in the medium and longer term, enhance shareholder returns in the Japanese market.

Moving on to Europe ex UK, the ECB, as expected, raised its benchmark interest rate in June from 3.75% to 4.0% and there are expectations of a further rise or rises, especially as the ECB raised its inflation forecast this year to a range with a mid point of 2.0%, and the same level next year. The first estimate of inflation for June was 1.9%. Although there were slight changes in the nuances of the President of the ECB's language, inflation was the ECB's main concern and interest rates were described as accommodative. A possible risk to growth was the mispricing of risks in the financial markets. Interestingly, he gave a hint, which was also echoed by the IMF's



Chief Economist, that the potential growth rate of the eurozone economy, consistent with stable inflation, might be higher than thought. If that is the case, it might make the ECB more relaxed about economic growth which could mean interest rates lower than would otherwise have been expected.

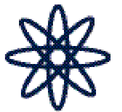
As a central bank, the ECB has been vigilant about money supply growth. In May, the annual rate of growth rose to 10.7% from 10.4% in April, nearly back to March's high of 10.9%. Lending to business rose at an annual rate of 12.6% in May compared with 12.2% in April. Lending for house purchase remained unchanged at 8.0% whilst there was some slowdown in the lending to individuals at 7.4% against 7.6%.

As one would expect, given the buoyancy of the eurozone economy, specific indicators have been generally positive. Eurozone unemployment has fallen to 7.1%, the lowest level since records began in 1993. The Purchasing Managers reported a positive result for May to add to evidence of strength. The EC's economic sentiment index fell slightly in June, by 0.4 to 111.7 but this was still a strong showing with business particularly positive. The only major statistic of weakness was rather weak industrial output in April when a month on month decline of 0.8% was seen.

Looking at individual countries, the strength of the German economy is helping to establish a much needed turnaround in state finances. The ratio of state spending to GDP fell from 47.1% to 45.6% between 2004 and 2006. Less crowding out of the private sector should help to raise the economy's growth rate, a long term positive for equity markets. Unemployment continues to fall, albeit from a very high level. It was down by 37,000 in June on a seasonally adjusted basis. However, perhaps because unemployment remains high in absolute terms and because of the after effect of the 3% VAT rise on 1 January, consumers are reluctant to spend. Between April and May, retail sales fell by 1.8%. There was also a drop in the ZEW investment sentiment survey which fell from 24.0 in May to 20.3 in June. Why this should be so is difficult to say other than perhaps a reaction to a strong stock market performance.

The most interesting country in the eurozone at present is France because of the reforms that the new President, Mr Sarkozy, has said that he will introduce. France needs to change as it falls behind Germany in the economic growth stakes but change is not easily made in France. Labour market reforms centre around reducing the impact of the 35-hour working week, a symbol of a policy that is completely out of date in a very competitive international environment. But tax policies, too, need to change to bolster France's competitive position in a world where many countries are trying to reduce tax rates to bolster their attractions. The problem for Mr. Sarkozy is that France is very constrained by the restrictions of Maastricht on the size of budget deficits and he needs some understanding from his eurozone partners which may be difficult. His tax cutting plans, which he rightly sees as very important to his economic strategy, might conflict with the timetable for borrowing reductions. The scene is set for a clash with eurozone finance ministers. Meanwhile, as often happens after elections, there is a boost in customer confidence and this has been the case in France where the EC, at the end of May, reported a "dramatic increase" in consumer confidence across the EU which had been heavily influenced by a sharp pick up in France. Insee has produced an optimistic forecast for France. Due to wage increases, lower inflation and tax cuts, it sees French households enjoying a substantial increase in purchasing power in 2007. It forecasts net job creation of 303,000 this year compared to 256,000 in 2006. It forecasts average growth of 2.1% this year with growth accelerating through the quarters. Insee sees two of Mr Sarkozy's policies contributing to increased growth this year, tax breaks on overtime and on mortgage interest payments. Although, from an economic perspective, the type of protectionism the new President espouses is unwelcome, these type of domestic reforms, just mentioned, are what France badly needs. We have, therefore, a rather paradoxical situation in France and one must hope that the supply side reforms triumph over the protectionist tendencies.

One area where Mr Sarkozy is likely to receive opposition within the EU is in his wish to have greater political control over the ECB. Any such interference would lead to strong objections from Germany. Mr Sarkozy blames the woes of Airbus, for instance, on the strength of the euro. Here is a business which has much of its revenue in US



dollars and much of its costs in euros. The cost cutting plan which Airbus wishes to embark upon is being fiercely resisted by politicians and trade unionists alike, but more efficient operating practices are inevitable if Airbus is to compete with such an effective competitor as Boeing. Political meddling would undermine the credibility of the euro but the problem is with the concept of the euro itself where a single interest rate is unsuitable for such a diverse bloc of countries. Whilst this has always been apparent, the difficulties it is creating for the eurozone are coming clearer. A country like Spain, which has grown rapidly, has lost competitiveness because its inflation rate has been relatively high. The country has a very large current account deficit, about 9% of GDP, which, if it were not in the euro, could have caused currency problems. But it is an economy heavily dependent upon the construction sector and, if trouble develops, the central bank would not have the ability to reduce interest rates unilaterally. So, against a good economic background for the eurozone generally, difficulties may be looming in some areas.

We have discussed earlier on the position of China on the international scene as it comes under continuing pressure to do something about its trade surplus which is causing such friction in the west. Domestically, the authorities are working hard to restrain the economy, the latest consumer price index for May rose 3.4% year on year, and dampen down speculative bubbles. In an attempt to discourage speculation on the stock market, it trebled stamp duty to 0.3%. Significant amounts of money have been withdrawn from bank deposits to invest in shares. According to the People's Bank of China, net household deposits in the Chinese banking system fell by the equivalent of £18.5 billion in April. Quite rightly, to alleviate the danger of speculative excesses, the authorities are looking to loosen the restrictions on individuals being able to invest overseas. In this respect, the Chinese Securities Regulatory Commission issued new regulations which allowed securities firms and fund management companies to apply for qualified domestic institutional investor quotas to invest in offshore securities.

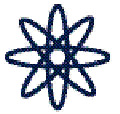
In reacting to pressure from outside about its large and growing trade surplus, China cut or abolished export tax rebates for some of its largest export categories.

Of potentially great significance for international investors in the medium and long term, and relating to our discussion of Sovereign Wealth Funds earlier, China is moving on with the establishment of its state investment agency, with the Finance Ministry soon going to issue US$200 billion in bonds to capitalise it. Even that equates to only a very modest proportion of its foreign currency reserves which currently stand in excess of US$1,200 billion. The aim will be to increase returns with that tranche of funds.

So, China remains an increasing investment story whether it be because its rapid growth helps to sustain the world economy or because its vast reserves promise to have a significant impact on securities' markets in the medium and longer term.

We noted in the Financial Times, in June, reports of a speech made by the President of the New York Federal Reserve in Singapore in which he referred to the importance of the build up of Asian foreign currency reserves which had doubled since 2003 to US$2,500 billion. In one way, this provides some comfort after the problems caused by the Asian financial crisis ten years earlier but the President was also referring to the distortions in the international financial and economic situation caused by the exchange rate policies of Asian countries. We have already discussed the protectionist developments in the west caused by China's growing trade surplus.

The Australian economy has performed remarkably well for very many years and the news continues to impress. In the first three months of this year, the Australian economy grew by 1.6% compared with the final quarter of 2006 and, on an annualised basis, the economy grew by 3.8% in the year to March 2007. Stronger consumer spending and business investment lay behind the good performance. The outlook remains good, despite the malign effects of the drought which reduced first quarter growth by 0.2%, with strength in the mining sector boosting the economy. Because of the prolonged strength of the Australian economy, which has resulted in very low unemployment, the Reserve Bank of Australia was the first major central bank to raise interest rates in this



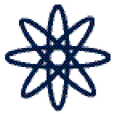
cycle and, apart from New Zealand, short term interest rates are amongst the highest in the OECD at 6.25%. However, the new Governor of the Reserve Bank of Australia recently indicated a more cautious approach to raising interest rates further because of better than expected inflation figures. The outlook for Australia continued to look good with the only fly in the ointment being the large current account deficit at around 6% of GDP. With good economic growth prospects, there is unlikely to be any problem in the foreseeable future in financing the current account deficit. There is an election due to be held fairly soon and, with the opposition ahead in the polls, investors will need to consider the opposition's economic policies in case it could be a market factor. Overall, despite the good performance of the Australian stock market, it is likely, at the very least, to perform in line with world markets.

Finally, we turn to the UK, which has performed close to average during the last quarter. The most immediate economic issues are the course of short term interest rates, inflation, the housing market and its affordability in terms of the level of house prices and the servicing of mortgages taken out on the properties.

We now know that the June meeting of the MPC only narrowly agreed to maintain interest rates at 5.5%, with the Governor of the Bank of England being in the minority of four who voted for an interest rate increase. It is likely that it was only a timing issue for some of those who voted for the status quo, and the next meeting is expected to endorse a rise to 5.75% (now confirmed). Whilst decisions are made by a majority on the MPC, it is not ideal that the Governor is on the losing side. The one time this happened previously was in August 2005 when the MPC voted for a cut and it is now widely accepted that the Governor and those who voted with him against an interest rate reduction were correct. Some of the problems of inflation which have arisen since then stem back to that decision. The view of those who voted for an increase to 5.75% at the June meeting was that growth needed to slow down to below the economy's potential growth rate consistent with stable inflation in order to meet the 2% inflation target in the medium term. Other reasons put forward to raise interest rates in June were a feeling that there was not enough evidence that household spending was easing and still strong house price inflation and money supply growth. Strong business investment, capacity pressures and oil prices were also cited. The hawks felt that if interest rates were raised then, the eventual peak could be lower. The doves, who won the day, pointed to a subdued labour market and muted pay growth. They were concerned about the effect of earlier interest rate rises on consumption and did not feel so positive on household consumption and the housing market. In a speech later in June, the Deputy Governor, who had backed the Governor in the vote, felt that current interest rates were too low to curb growth in credit and demand. This thinking was that the danger of a loss of economic growth was preferable to taking a risk with inflation and the Bank of England's credibility.

In terms of inflation, the latest producer price index for May showed a year on year increase of 2.5%, the same level as in April. The "core" figure, excluding volatile items, was up 2.4%. Input prices were up 1.2% on an annual basis. The consumer price index rose by 0.3% between April and May to leave the annual rate at 2.5% compared with 2.8% for the year to April and 3.1% for March. The "core" annual rate rose from 1.8% in April to 1.9% in May. One of the surveys carried out for the Bank of England is on people's expectations for inflation, obviously important for policy, and the latest figure for the coming year remained unchanged at 2.7% from February. Various surveys also record pricing power, an important indicator for the Bank of England. The latest CIPS/NTC Economics Survey of the manufacturing sector suggested increasing pricing power for companies. On the other hand, a less bullish picture emerged for the same organisation's survey of the services sector. The CBI put manufacturers' pricing power at fairly elevated levels but noted that companies had become less bullish about raising charges. Some possible softness in the labour market may account for a fairly subdued earnings picture. During the three months to the end of April, average earnings growth, excluding bonuses, remained at 3.6%. The figure, including bonuses, was 4.0%.

All the surveys of house prices continue to show price increases, but at different levels. The Halifax reported an increase of 0.3% in May compared with April to give a year on year increase of 10.6% compared with 10.9% in



April. The FT house price index showed prices in England and Wales rising by 0.5% to give an annual increase of 8.5% compared with 8.4% in April, with the rise very much skewed to London. The Nationwide survey, covering June, showed a sharp increase of 1.1% compared with May to give a year on year rate of 11.1%, up from 10.3% in May. On its measure, this was the biggest rise since January 2005. The Council of Mortgage Lenders reported record gross lending in May but some slowdown in the year on year growth rate. The British Bankers Association reported that the number of loans approved for house purchase in May was 3.6% lower than a year earlier although still at a high level. The effect of interest rate movements is lagged and further evidence is needed over coming months to see if the Nationwide's figures are more indicative of the trend or whether other evidence, suggesting a slowdown, is valid. But in terms of affordability, as mortgages taken out earlier at lower rates are refinanced at higher rates, house owners will feel the squeeze which will impact on household spending and the economy in general. That consumers are stretched is shown by the fact that the household savings ratio has fallen to its lowest level since the beginning of the 1960's, a mere 2.1% in the first quarter of 2007 compared with 3.9% in the fourth quarter of 2006. Real household disposable income fell for the second consecutive quarter in the first quarter of 2007. These trends point to a slowdown in consumption as households face this more difficult situation. As we have often mentioned before, government finances are not in a healthy state and there may be further tax increases to aggravate the situation which is developing.

If this review has spent some time discussing potential economic and political problems, it is because the generally benign economic outlook has encouraged unnecessary levels of risk taking in some areas which we have mentioned. To us, however, equities still appear to be reasonably priced and, despite their fall, we think longer dated bonds remain overpriced. Given the steady upward movement in equities, reflecting a strong rise in corporate earnings, it is realistic to expect a negative quarter, or quarters, coming up soon. However, against the economic outlook as we see it at present, in the absence of a geopolitical shock which we cannot presently foresee, we think it unwise to introduce liquidity given the potential opportunity cost of doing so, should shares move ahead as is their likely medium and long term trend. The loss of profit in such a situation cannot be recovered if shares do not revert to those lower levels.

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